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FEDERAL COMMUNICATIONS COMMISSION
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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

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| In the Matter of | ) | |
| | ) | |
| Implementation of Sanctions of the Cable Television Consumer Protection and Competition Act of 1992 | ) ) ) | MM Docket No. 92-266 |
| | ) | |
| Rate Regulation | ) | |

# REPLY COMMENTS OF GTE

GTE Service Corporation and
its affiliated domestic
telephone operating companies

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## SUMMARY

The Commission has affirmed its intent to use a benchmark formula to establish initial rates and to then permit price changes based on a price cap model in its *Rate Reconsideration Order*. GTE notes that the Commission has rejected cost-of-service regulation other than as a backstop. While GTE and others have suggested ways to strengthen the regulatory scheme, the parties tend to agree that as far as principles are concerned, the Commission "got it right." The issues raised in the *Third NPRM* must be addressed using methods consistent with the principles established. The best path is to return to the basic principles that Congress and the Commission articulated and use those as the "touchstones" for dealing with these remaining issues. The cable operators' comments fail to do so and the Commission must not be swayed by their siren song.

The third option for the addition and deletion of channels should be rejected in favor of a modified version of the first option which corresponds more closely with the overall benchmark/price cap scheme. The third option is a cost plus scheme where a system's own costs are used to determine rates through external treatment of its own programming costs or all upgrade costs. This option rubbed against the touchstone proves to be nothing more than dross.

Parallel treatment of the two tiers is necessary to support the Commission's basic principle of tier neutrality at least until a method of cost allocation is developed in the *Cost-of-Service NPRM*. Finally, external treatment for system upgrades should only be granted when the upgrade has been mandated and is out of the control of the cable operator.

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# REPLY COMMENTS OF GTE

GTE Service Corporation and its affiliated domestic telephone companies ("GTE") reply to a number of comments[1] filed in response to the Commission's release on August 27, 1993 of its First Order on Reconsideration, Second Report and Order, and Third Notice of Proposed Rulemaking in this Docket and urge the Commission to remain true to the benchmark/price caps scheme it has adopted.

## I. Introduction.

The Commission has affirmed its intent to use a benchmark formula to establish initial rates and to then permit price changes based on a price cap model in its *First*

1 Austin, Texas, et al. (Coalition), Cablevision Systems Corporation (Cablevision), Continental Cablevision, Inc. (Continental), Falcon Cable TV, et al. (Falcon), The Hearst Corporation (Hearst), National Cable Television Association (NCTA), Tele-Communications, Inc. (TCI), Time Warner Entertainment Company, L.P. (Time Warner), Viacom International Inc. (Viacom).

*Reconsideration Order.*[2] GTE noted in its comments filed on September 30, 1993, in response to the *Third NPRM* that the Commission has rejected cost-of-service regulation other than as a backstop.[3] While GTE and others have suggested ways to strengthen this regulatory scheme, parties tend to agree that so far as the principles are concerned, the Commission "got it right." The issues raised in the *Third NPRM*, the proposed methods to govern rates when channels are changed or plant up-grades made and the application of cost of service options, must be addressed using methods consistent with the principles established. The cable operators commenting here fail to do so, and the Commission must not be swayed by their siren song.

## II. Success of the Commission's regulatory scheme depends on adherence to the principles established.

Congress directed the Commission to design a regulatory scheme that (i) would result in prices and offerings as if the regulated systems were subject to competition; and (ii) would be as simple as possible in assuring that rates were reasonable in relation to costs.[4] The competitive standard necessarily implies that prices must approach long run marginal cost and that firms have incentives to behave efficiently and expand or improve product offerings. The Commission's benchmark/price cap scheme adheres to these principles.

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2 Implementation of the Cable Television Consumer Protection and Competition Act of 1992 - Rate Regulation, MM Docket No. 92-266, Report and Order and Further Notice of Proposed Rulemaking, FCC 93-177 (released May 3, 1993), 1993 FCC LEXIS 2417 ("*Rate Regulation Order*"), First Order on Reconsideration ("*First Reconsideration Order*"), Second Report and Order, and Third Notice of Proposed Rulemaking ("*Third NPRM*"), FCC 93-428 (released August 27, 1993), *review pending sub nom. Columbia Associates, L.P. v. FCC*, No. 93-1409 (D.C. Cir., June 22, 1993) .

3 GTE at 3, *Third NPRM.*

4 H.R. Conf. Rep. No. 102-862, 102d Cong. 2d Sess. 62.

Many of the proposals supported by the cable operators violate the basic principles of the Commission's chosen regulatory scheme.[5] Price cap regulation only provides incentives toward efficient behavior when an individual company's prices are decoupled from its costs.[6] The proposals that flow through all programming costs or system upgrade costs effectively remarry the firm's own costs and prices, destroying the efficiency incentives, incentives that would be active in the competitive market. The result is cost plus regulation,[7] in clear opposition to the Congressional directive. Worse yet, the proposals here would permit cable operators to pick and choose what cost changes are revealed and reflected in rates. For example, system upgrade costs may well be offset by decreased labor and maintenance costs, yet the cable customers would not see those savings if TCI's proposal were adopted. TCI erroneously claims

> the documentation of key factors, including upgrade costs, can be accurately ascertained without a full cost-of-service showing. Moreover, there is no compelling reason to saddle cable operators, franchising authorities, and the Commission with a costly and burdensome full cost-of-service showing when only one key cost factor will be at issue.[8]

The Commission has already determined that benchmarked initial rates and a price cap to govern future rate changes is the ratemaking scheme. In making that decision the Commission specifically rejected adoption of cost based regulation, noting that cost-of-service is to be utilized as a backstop.[9] Comments such as TCI's are at best a disingenuous effort to sidestep and ignore the Commission's ruling. What is

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5 *See* TCI at 4, Cablevision at 5, NCTA at 6, and Viacom at 9.

6 Dr. Mark Schankerman fully explains the necessity to decouple, GTE Attachment at 6, *Third NPRM*. Further, the rules must hold and provide symmetry. That is, companies must believe that the regulatory system is binding and both risk and reward must be part and parcel of the scheme.

7 GTE Attachment (Schankerman) at 3, *Third NPRM*.

8 TCI at 4.

9 Cost of Service NPRM at paragraph 7.

needed is not further efforts to move cable rate regulation into some form of cost-of-service regulation, instead commenters should be addressing how the Commission can clarify and strengthen its benchmark price cap methodology. If the Commission succumbs to this siren song, that cost plus is the required methodology, the present public outcry that the 1992 Cable Act[10] has not met expectations will swell.

Confusion abounds over just how the Commission will proceed with day to day application of the regulatory scheme it has laid down. Parties seem to view differently the mechanics that actually determine what rate changes will be allowed. For example, Hearst Corporation presents arguments that the use of the benchmarks to establish the rate change allowed or required when channels are added or deleted from one tier would necessitate changes in the price for the other tier.[11] GTE agrees with Time Warner "that whatever methodology the Commission settles on, it should be applied within tiers rather than across them in order to prevent anomalous, if not perverse, results."[12] Nothing in the Commission's decision in the *Rate Regulation Order*, the *First Reconsideration Order*, or this *Third NPRM* would mandate such a tie when channels are changed.[13] Further, there is no need or expectation that prices on either tier will always move precisely in concert with the Price Cap Index (PCI) change. Cable

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[10] Cable Television Consumer Protection and Competition Act, Pub. L. No. 102-385, Section 2(b)(4), 106 Stat. 1460 (1992) ("1992 Cable Act").

[11] Hearst Corporation at 5, Falcon at 7, TCI at 2, Continental at 11, NCTA at 4, and Joint Parties at 8 also reach this conclusion

[12] Time Warner at 4.

[13] See *Rate Regulation Order* at paragraph 197, n.501. Indeed, Joint Parties acknowledge the problem, noting that the rules "are ambiguous" and seek answers to their confusion. Joint Parties at 2-3.

operators may chose to price below the cap or to not fully exercise the allowable increase one year but to "bank" it for use in future years.[14]

There is also confusion from the fact that the Commission has not specified whether the basic tier and cable programming services (enhanced) tier will have separate PCIs similar to the separate service baskets under the LEC price cap scheme or how the PCIs will be implemented. There may be a number of reasons that the PCI of one would differ from the other. For example, if the Commission maintains that programming costs are external, it is reasonable to assign changes in programming costs of specific channels to the tier in which the subject channel resides. In LEC price cap terms this would result in basket (tier) specific "z factor" adjustments. The Commission, however, has not delineated the specific treatment of external factors. Similarly, much of the implementation is undefined. For example, Time Warner proposes that the Commission specify a 90-day notice before basic rate changes become effective subject to refund.[15]

Because there is as of yet little specificity or stated formulae, evaluation of the issues in this *Third NPRM* is somewhat stymied. These questions must be addressed and answered to complete the price cap methodology, rather than to draw the Commission into entanglement of cost-of-service regulation. The best path is to return to the basic principles that Congress and the Commission articulated and use those as the "touchstones" for dealing with these remaining issues, including a more detailed specification of the ongoing price cap scheme.

GTE has proposed that the Commission address these uncertainties by revisiting the benchmark formula, and by adopting GTE's proposed Competitive Price

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[14] GTE construes the Commission's language in Section 76.922(c) to apply to the PCI, and not to the actual rate.

[15] Time Warner at 5, NCTA at 10.

Cap Model.[16] The record has now been completed, here and in the *Cost-of-Service NPRM*,[17] to permit the Commission to fill in the spaces and address complete price cap rules.

## III. The third option for the addition and deletion of channels should be rejected in favor of a modified version of the first option corresponding more closely with the overall benchmark/price cap scheme.

The third option for channel changes, either as defined by the Commission or with the adjustments proposed by TCI, NCTA and Viacom,[18] rubbed against the touchstone proves to be nothing more than dross. It is a cost plus scheme where a system's own costs are used to determine rates through external treatment of its programming costs or all upgrade costs. Further, the system's own average cost for nonprogramming components would be used because this option maintains the differential between initial regulated rates and the benchmark. Firms who add or delete channels are not driven to efficient behavior through an external yardstick nor treated equitably since firms whose rates were lower than the benchmark are granted a smaller rate increase than those whose unregulated rates were more than 10 percent higher than the benchmark.

If the Commission is to attain its stated objectives, it must reject the third option. It violates the principle of decoupling of a firm's own cost from its price, eliminates incentives, and adds unnecessary complexity.[19] GTE agrees with the concept of

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[16] GTE at 14, 18, *Cost of Service NPRM*. The theoretical foundation for the model proposed by GTE is articulated by Dr. Schankerman. *Id.*, Attachment at 8-14.

[17] Implementation of the Cable Television Consumer Protection and Competition Act of 1992 - Rate Regulation, MM Docket No. 93-215, Notice of Proposed Rulemaking, 58 F.R. 40761 (July 30, 1993) ("*Cost-of-Service NPRM*").

[18] TCI at 7, NCTA at 4, Viacom at 7.

[19] TCI at 1.

capturing the "economies of scale observed in the benchmark rates."[20] But, GTE believes those economies will be best reflected if option one, using the benchmark directly, is properly applied.[21] This requires that the benchmarks be refined. Time Warner agrees that the benchmarks need improvement and urges the Commission to focus on that task.[22]

**IV. Parallel regulatory treatment of the two tiers is necessary to support the Commission's basic principle of tier neutrality at least until a method of cost allocation is developed.**

The Commission has sought comments here whether cable operators should be allowed to file for different regulatory treatment in each tier or whether parallel treatment must prevail in order to preserve the Commission principle of tier neutrality.[23] Tier neutrality preserves administrative simplicity and discourages any attempts to "game" the process by flowing higher costs to the tier to which a cost-of-service showing has been employed.

The majority of cable operators[24] commenting incorrectly urge the Commission to reject its tentative conclusion[25] that parallel treatment of methodology is required. Time Warner suggests that gaming is not a threat because there is no motivation to shift programming costs between tiers since programming costs are treated externally. GTE concurs that programming costs probably would not be shifted but there is evidence placed in the record by GTE that programming only averages approximately

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20 *Third NPRM* at paragraph 140.

21 GTE at 4, *Third NPRM.*

22 Time Warner at 4. Also, Joint Parties at 6.

23 *Third NPRM* at paragraph 148.

24 Time Warner at 6, Continental at 2, Cablevision at 3, NCTA at 15.

25 *Id.*

35 percent of the costs incurred by cable operators.[26] Capital and labor costs for joint and common plant represent a large percentage of the total system cost and could be shifted or "gamed" between tiers if parallel treatment were not applied to both tiers. Consequently, there is still a threat of gaming the process.

Several commenters continue to oppose tier neutrality because they conclude that the *Rate Regulation Order* does not require that both tiers have the same price per channel.[27] The Commission's rule that initial reductions in rates of an individual tier were limited to the lesser of 10 percent or the benchmark level also creates the possibility that a cable operator may be enriched by selective use of cost-of-service.[28] The table below uses an illustrative benchmark rate of $.40 per channel to demonstrate this.

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[26] GTE Attachment (Schankerman) at 17, n.27, *Cost-of-Service NPRM.*

[27] TCI at 5-6, Time Warner at 9, NCTA at 16, Joint Parties at 12.

[28] *Rate Regulation Order* at paragraphs 216, 217, 396.

| | Basic | Enhanced | Total |
|---|---|---|---|
| Channels | 10 | 10 | 20 |
| Pre-regulated price | $2.00 | $8.00 | $10.00 |
| Benchmark price | $4.00 | $4.00 | $8.00 |
| Commission initial price rules | $2.00[29] | $7.20[30] | $9.20 |

Since the basic rate is one-half the benchmark rate, it is likely that an operator could justify a basic rate increase in a cost-of-service showing. This would ignore the fact that the Commission's rules allowed the enhanced tier price to remain far above the benchmark, and presumably the cable operator is able to extract greater revenues from this service than a cost showing would support. An actual comprehensive examination of the firm's total costs and revenues is necessarily to ensure there is no over recovery of costs. If the Commission accepts arguments that tier neutrality of methodology is not necessary it should reexamine its decision to limit rate decreases to 10 percent.

The logic of mixed methodologies ultimately breaks down. As GTE pointed out earlier, cost-of-service is designed as a backstop or secondary choice to benchmarking. But if used selectively on either basic or enhanced rates alone, the cost-of-service method of necessity becomes primary. This is because the process of identifying and allocating the costs that are common to all regulated tiers necessitates the spillover of the results even to the benchmarked tiers. That is, the costs identified as attributable to the benchmarked service must be accounted for by the benchmarked

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[29] Below benchmark rates cannot be increased. GTE has suggested that the Commission should permit a cable operator to increase basic rates if they are below the benchmark to offset decreases in enhanced basic rates. GTE Opposition to Petitions for Reconsideration at 11. While the Commission denied the suggestion (*First Reconsideration Order* at paragraph 14), the issue should be dealt with here.

[30] Above benchmark rates are not required to decrease more than 10 percent.

prices.[31] If the Commission were to use the fact that both tiers do not require the same price per channel to revoke its rule for tier neutrality here, the natural result is a requirement for a full system of accounts and jurisdictional separations similar to Parts 32 and 36. It is a simple fact that without consistent cost allocation between tiers, different types of regulation cannot be applied to each tier. A cable operator can produce a different price per channel in each tier but those prices must be based on the costs in each tier if a cost-of-service showing is to be employed. Without consistent cost allocation, the Commission must require parallel treatment of regulation.[32]

Cablevision at 4 argues against parallel treatment because it concludes that since the Commission's rules require it to file cost-of-service showings for both tiers at the federal and local level, this will require more than two filings since they operate in a multitude of franchise areas. This assumes that cost-of-service filings will be the norm, an assumption that is not valid. Additionally, this assumes that the same rates would be sought in every franchise area, a result that will not occur under cost-of-service with jurisdictional allocation of common cost plus the individual jurisdictional cost.

The arguments for revocation of the Commission's tier neutrality policies are weightless. The public policies articulated by the Commission in its *Rate Regulation Order* and the *First Reconsideration Order* have not been established to be invalid or unsupported by the record. Tier neutrality should be maintained.

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31 This reality is acknowledged by Viacom at 18 and by Media General at 2-3.

32 Continental at 4 has suggested that the Commission should adopt "reasonable rules" for allocating costs among the tiers. GTE and others have submitted their recommendations for cost allocation in the *Cost-of-Service NPRM* and as GTE suggested, *infra* at 5, Commission action utilizing the record in that proceeding as well as here would resolve substantially all issues raised.

## V. External treatment for system upgrades should only be granted when the upgrade has been mandated and is out of the control of the cable operator.

There still seems to be some confusion as to when a cable system should be granted external treatment for specific costs. Several cable operators commented that external cost treatment should be adopted for system upgrades completed immediately before the implementation of cable rate regulation[33] and upgrades mandated by local authorities.[34] There is an important distinction between these two types of upgrades, one was mandated and outside the control of the operator and the other was a conscious choice by the operator.[35] External costs have been defined by the Commission as costs which are "largely beyond the control of the cable operator, and should be passed on to subscribers without a cost-of-service showing."[36] Therefore, as GTE stated in its comments, since mandated upgrades are largely beyond the control of the operator it should be granted external treatment to the degree that those costs are not already reflected in the PCI.[37] As Continental states at 18, if these mandated costs are not treated externally it will "create irresistible incentives for local franchise authorities to require upgrades without regard to market demand for, or subscriber interest in, the services and service enhancements the upgrades would make possible." These are, however, the only upgrade costs that should be afforded this treatment.

System upgrade costs completed prior to regulation should not be treated externally for two reasons, beside the fact that they were within the control of the cable

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33 Time Warner at 11, TCI at 3, Viacom at 14, NCTA at 13.

34 Continental at 17-18, Viacom at 16, Cablevision at 7, NCTA at 19.

35 NATOA's comments miss this important point. It is not the extraordinary cost (NATOA at 9), it is the fact the upgrade is beyond the control of the cable operator and would not be incurred at that point in time absent regulatory mandate.

36 *Rate Regulation Order* at paragraph 254.

37 GTE Comments at 12-13.

operator. First, the Commission has held that there is a presumption that the initial rate the cable operator charged covered its system costs. Second, if the rates are not adequate, the operator always has the option to file a cost-of-service study. As GTE stated in its Comments at 10, if the Commission fears that the benchmark did not adequately capture the fundamental cost causation factors, then it should refine the benchmark, not try to correct for any limitations by adding "escape valves." These concerns can be dealt with through a recast of the benchmark regression analysis including additional cost causation variables.

Respectfully submitted,

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October 7, 1993

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## Certificate of Service

I, Javae D. Smith, hereby certify that copies of the foregoing "Reply Comments of GTE" have been mailed by first class United States mail, postage prepaid, on this 7th day of October, 1993 to all parties of record.

Javae D. Smith